

Abstract

This thesis consists of two essays on the impact of non-financial information on a firm's risk, profitability and valuation. In the first essay titled 'The impact of toxic pollution on firm risk, profitability and valuation', I study the impact of toxic pollution on the said measures in the context of a developed economy, i.e. U.S.A. In the second essay titled "Value Relevance of Environmental, Social and Governance Performance in India", I analyse the impact of Environmental, Social and Governance (ESG) information on the risk, profitability and valuation in an emerging market context, i.e. India.

In the first essay, I find that in the U.S.A., polluting firms have higher idiosyncratic risk. The result can be attributed to increased litigation risk for polluting firms. Toxic pollution is an externality that negatively affects the health of employees and local community members that come in contact with it thus increasing the risk of retaliatory litigation from affected parties. In addition, it increases the likelihood of accidents, costly regulatory supervision from government agencies and the possibility of shareholder activism. The result is qualitatively similar whether risk is measured using stock returns data or accounting data.

Polluting firms in my sample have higher future profitability. The results imply that pollution control is costly and in the short run, expenditure on pollution abatement activities has negative impact on a firm's net income. The result is robust to the choice of profitability measure. The risk and profitability findings also support Rubinstein's [1973] mean-variance theorem. Mean-variance theorem states that return of an asset is directly proportional to the risk of that asset. Assets with higher expected risk are expected to earn higher return. Consistent with the theorem, I find that polluting firms have higher firm-specific risk and higher returns.

Consistent with earlier empirical literature, I find that polluting firms in my sample have lower market valuations. Given the fact that pollution propensity is unlikely to impact systematic risk; the idiosyncratic risk, profitability and market valuation results imply that firm-specific risk due to toxic pollution is priced by market participants. One of the possible explanations for this phenomenon is that an unidentified systematic risk factor is currently part of the idiosyncratic risk. Consistent with this idea, existing literature also illustrates some of the conditions under which firm's idiosyncratic risk is priced in stock returns (Goyal and Santa-Clara [2003]; Campbell, Lettau, Malkiel and Xu [2001]; Malkiel and Xu [2001]; Merton [1987]).

In the second essay, I examine the effects of environment, social and governance (ESG) performance on firm's market value, profitability and risk in an emerging economy context. I look at Indian data from 2005 to 2009 and find that ESG performance does not impact market value of stocks. However, I find that ESG performance impacts the two primary market value drivers – profitability and risk. ESG performance has a positive impact on profitability and reduces CAPM beta and variance of stock returns. I also find that ESG performance and profitability are simultaneously determined. My study provides insights on investor behavior from emerging markets. This is, also, the first study in the ESG domain which uses simultaneous equations to control for possible endogeneity between ESG performance and firm profitability.